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In the Supreme Court of the United States

October Term, 1943

No. 276

The Security Flour Mills Company, petitioner
v.
Commissioner of Internal Revenue

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH DISTRICT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinions of the United States Board of Tax Appeals (R. 32–49) are reported in 45 B. T. A. 671. The opinions of the Circuit Court of Appeals (R. 61–71) are reported in 135 F. 2d 165.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 6, 1943. (R. 72.) A petition for rehearing was denied on May 22, 1943. (R. 73.) The petition for a writ of certiorari was filed on August 21, 1943, and was granted on October 11, 1943 (R. 74). The jurisdiction of this

Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under Sections 23 (a), 41 and 43 of the Revenue Act of 1934 the taxpayer is entitled to deduct from its gross income for 1935 payments aggregating $45,865.90 which it made to certain of its customers in the years 1936, 1937 and 1938.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 38 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> SEC. 41. GENERAL RULE.
>
> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 43-1. *"Paid or incurred" and "paid or accrued."*—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in

his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

STATEMENT

This case involves petitioner's liability for income and excess profits taxes for the year 1935. The facts as found by the Board of Tax Appeals may be stated as follows:

The taxpayer is a corporation organized under the laws of Kansas, with its principal place of business at Abilene, Kansas, engaged in the manufacture and sale of wheat flour. It reported its net income on the accrual basis of accounting. As a first domestic processor of wheat it was subject to the processing tax levied under the Agricultural Adjustment Act. (R. 34.)

During the period from January 1, 1935, to May 1, 1935, the taxpayer paid to the Collector of Internal Revenue certain processing taxes and claimed and was allowed the amount so paid as a deduction from gross income in its federal income tax return for the year 1935. The amount so paid is not in issue herein. (R. 34.)

On June 29, 1935, the taxpayer instituted a suit in the District Court for the District of Kansas seeking to enjoin the further collection of processing taxes levied under the Agricultural Adjustment Act. A temporary injunction was granted on July 24, 1935, effective from May 1, 1935, enjoining the further collection of the processing tax, on condition that, pending the final determination of the constitutionality of the Agricultural Adjustment Act, the taxpayer file information returns with the Collector and deposit in a bank, designated as the depository of the court, a sum of money equal to the tax shown to be due by the information returns. During the period from May 1 to December 31, 1935, the taxpayer paid into the depository a total of $93,974.40. In addition it accrued upon its books the sum of $9,896.66 as a liability for the processing tax for the last month of the period, plus an additional item of $1,183.64 representing a reserve for possible increases in the processing tax for prior years, but these latter two items were not paid to the Collector or to the depository. (R. 34.)

On January 6, 1936, the taxing provisions of the Agricultural Adjustment Act were held unconstitutional. *United States* v. *Butler,* 297 U. S. 1. Thereafter certain of the taxpayer's vendees filed intervention petitions in the injunction proceeding seeking to have the impounded money returned to them. The taxpayer resisted these petitions upon technical grounds and they were

denied on February 28, 1936. On the same day the District Court entered an order making permanent the temporary injunction theretofore granted and directing the depository to pay over to the taxpayer the $93,974.40. This amount was paid over to the taxpayer on February 28, 1936. (R. 34–35.)

The taxpayer's sales of flour from May 1 to December 31, 1935, were made at a stated price per barrel. The selling price consisted of the usual items of cost, plus normal profit, and included in addition an amount sufficient to cover the processing tax. The invoice reflected the contract price, but did not show the tax as a separate item. The contract price was included in the gross sales entered on the taxpayer's books. More than 50 percent of such sales were made under the Miller's Federation Uniform Sales Contract. (R. 35–36.) The pertinent reference to processing taxes in the contract is as follows (R. 36):

> The price named in this contract includes all taxes as at the date hereof proclaimed by the Secretary of Agriculture by virtue of the authority vested in him by the Agricultural Adjustment Act. * * * Under said Act it is provided that said taxes may be changed from time to time. It is recognized * * * that there is a growing tendency on the part of the United States and the separate states to tax grain * * * used in connection with the man-

ufacturing, processing, blending, sale or distribution thereof. It is therefore, agreed * * * that if, after the date of this contract, the commodities * * * used in connection with the manufacturing, processing, blending, sale or distribution thereof, shall become subject to any increase in taxes or to any new or additional tax or taxes other than those included in the price hereof, (if the seller shall be required by law to collect such increases or additional taxes) * * * said increases or additional taxes shall be added to the price hereof; and correspondingly if any tax included in the price hereof shall be decreased or abated, then in that event, said decrease or abatement shall be deducted from the price hereof.[1]

The taxpayer considered this provision of the Miller's Federation Contract to be applicable only to increases or decreases in the price between the date of the order and the date of shipment and as not creating any obligation to refund part of the price in case of invalidation of the Agricultural Adjustment Act. (R. 37.)

Following the receipt by the taxpayer of the impounded money from the depository, certain of its vendees instituted suit against it, claiming to be entitled to $1.38 per barrel of flour purchased

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[1] The deletions have somewhat distorted the sense of this provision. For a fuller quotation see *Moundridge Milling Co.* v. *Cream of Wheat Corp.*, 105 F. 2d 366, 367, fn. 4 (C. C. A. 10th).

by them during the injunctive period. The suits were based upon the Miller's Federation Contract and upon quasi-contractual and equitable trust fund theories. The suits were resisted and ultimately dismissed. (R. 35.)

As early as July, 1935, the taxpayer had been advised by counsel that if the Agricultural Adjustment Act should be held invalid the Government intended to recapture by new legislation a large part of the unpaid processing taxes and that it would therefore be inadvisable for the taxpayer to make any commitments to refund any definite amount or any percentage of the tax to its customers. On June 22, 1936, Congress enacted the Revenue Act of 1936, which provided in Title III for the imposition of the unjust enrichment tax and in Title VII for the refund of taxes paid under the Agricultural Adjustment Act. The taxpayer's counsel sought a ruling by the Treasury Department on the question whether the Miller's Federation Contract was an agreement, within the meaning of Title III, entitling the taxpayer to credit against its taxes under that title for refunds made to vendees. In the meantime counsel continued to advise the taxpayer not to make any definite commitments to its customers with reference to refund of the processing tax to them. (R. 36.)

Pursuant to this advice the taxpayer refrained from making any definite promises respecting refunds in all written communications to its vendees.

Through its officers, salesmen and brokers it orally informed some of them that it proposed to make an agreement with them as soon as all matters with respect to the impounded funds and unpaid taxes should be finally settled. It was stated that the taxpayer would treat them fairly and do as well by them as other mills similarly situated, but that no promise could be made to refund any definite amount to them. (R. 37.)

In November 1936, the taxpayer informed some of its vendees who had purchased flour under the Miller's Federation Contract that it intended to seek a final determination of its tax liability by the Treasury Department, and, after the amount of unpaid processing taxes passed on to vendees on which it would be subject to tax had been fixed, that it would seek permission to refund the whole of such amount to vendees, provided the Department would accept such repayment as an offset against unjust enrichment (Title III of the Revenue Act of 1936), income and excess profits tax liabilities, and provided the vendees would accept such amount in satisfaction of their claims. Later in 1936, the taxpayer was informed by its counsel that the Treasury Department had agreed to allow credit for reimbursements and it should proceed to make settlements with its vendees. The taxpayer thereupon commenced negotiations with some of its vendees and made agreements with some of them as to the amount to be repaid to them. (R. 37.)

During 1936, 1937, and 1938 drafts in various amounts were issued by the taxpayer to the vendees with whom agreements were made, aggregating (together with credits against the accounts of some of them) $45,865.90 ($2,475.03 in 1936, $41,879.50 in 1937, and $1,511.37 in 1938). Attached to each draft and made a part of it was a "Release Agreement," which, after referring to the difficulty of determining the exact amount of the processing tax which had been borne by the vendor and the vendee, recited that "the amount of the taxes shifted to vendee * * * was not more, and may be less than" the total of the draft and credit memorandum referred to in the agreement. By cashing the draft the vendee acknowledged full payment and satisfaction of, and discharged the vendor from, all demands, charges, claims, actions, and rights of action growing out of amounts paid on account of processing tax during the injunctive period and included in or added to the price of flour sold by the vendor to him; covenanted that he was the actual purchaser of the flour and the owner of the claim, that he was not a party to any pending action against the vendor, and that he had not authorized the institution or prosecution of any suit or action against it. The agreement also stated that nothing therein was to be construed as, or constitute an admission of, liability of the vendor to any other person, firm, or corporation and that all legal and equitable defenses, of which it might

be possessed, in any and all pending and future litigation against it, were expressly reserved. (R. 37–38.)

The taxpayer did not make refunds to all who had purchased flour from it during the injunctive period. Refunds were made to some customers who had purchased under the Miller's Federation Contract, irrespective of whether or not they had been promised fair treatment. In making refunds only regular customers were considered, and a large number of casual customers, or customers toward whom the petitioner felt no obligation, were ignored. The petitioner made no attempt to effect settlements with those to whom the promises to treat fairly had been made but who had not purchased under the Miller's Federation Contract. (R. 38.)

On a schedule attached to the taxpayer's income tax return for the year 1935, the amount of $908,613.29 was shown as "Gross sales, per Books". From this it deducted $106,604.02 as "Provision for allowances to Vendees of Processing Taxes" and added $103,887.54 representing accrued processing taxes which had not been paid. The resulting figure of $905,896.81 was reported as "Net Sales." The taxpayer had arrived at the amount of $908,613.29 as representing its gross sales in the following manner: From its total gross sales of $1,072,139.50, it deducted $163,-526.21 representing estimated processing taxes collected from vendees during the year; this in-

cluded, among other items, the $93,974.40 impounded in the depository and the $9,896.66 accrued upon the taxpayer's books as processing taxes for the month of December 1935, but not impounded or paid over to the Treasury Department. (R. 38–39.)

The Commissioner disallowed as a deduction $105,054.70, consisting of the following items (R. 39):

Processing taxes impounded and later (Feb. 1936) released to petitioner	$93,974.40
Accrued processing taxes Dec. 1935. Not impounded or paid over to treasury	9,896.66
Estimated processing reserve set up to provide for additional assessments for prior years	1,183.64
	105,054.70

The petition filed by the taxpayer with the Board of Tax Appeals assigned error in the disallowance of $101,783.89 of the above amount as a deduction. (R. 39.)

The income tax returns of the taxpayer for the years 1936 and 1938 are not in evidence, and the record does not show whether the payments to customers of $2,475.03 and $1,511.37 in those years were claimed as deductions, or whether they were allowed or disallowed by the Commissioner. The taxpayer's return for 1937 shows a net loss of $66,944.25, computed by including in the deductions claimed the sum of $43,390.87 representing payments to customers in that year in settlement of processing tax claims. (R. 39.)

The Board of Tax Appeals held (five members dissenting) that the taxpayer was entitled to deduct from its gross income for the year 1935 the $45,865.90 which it had paid to its vendees in the years 1936, 1937 and 1938. (R. 32–49.) The Circuit Court of Appeals (one judge dissenting) reversed the Board's decision, holding the taxpayer was not entitled to any deduction. (R. 61–71.)

SUMMARY OF ARGUMENT

The taxpayer is not entitled to deduct from its gross income for 1935 the payments which it made to its customers in 1936, 1937, and 1938. Assuming that the item was a business expense within the meaning of Section 23 (a), it plainly was neither paid nor incurred in 1935. It has long been well settled that a deduction may not be accrued so long as it remains contingent, but only when the fact of liability becomes fixed and absolute. This is of course but one illustration of the basic principle upon which our system of income taxation rests, *i. e.*, each tax year stands alone; the tax for one year is separate from that of any other.

The "unless" clause of Section 43 does not constitute an exception to this principle. That clause must be read as part of the entire statute, and it therefore permits the taking of a deduction in a year other than that in which the item is paid or incurred, *only when consistently with the annual nature of the tax* it is necessary to do so in order "to clearly reflect the income." It

thus applies to cases in which an item of expense such as interest or rental for a series of years is paid in a single year. The clause is not to be read as permitting departure from the system of separate fixed periods of return for the purpose of ascertaining the net result of particular transactions or the final outcome of a prior taxable period.

The "unless" clause must necessarily be read in harmony with the principle of separate annual periods, for that is the only standard afforded by the statute to determine whether income is "clearly reflected." While it is true that from the point of view of a particular transaction which extends over a period of several years, the effects of that transaction may be distorted by treating each year as a separate unit, it is equally true that from the point of view of the annual system the income of each of those years is distorted by grouping the effects of the transaction into a single year. It is impossible therefore to speak of the necessity of avoiding distortion of income unless the criterion has been fixed against which the alleged distortion must be measured. And the only standard available is that afforded by the cornerstone of the entire statute. What must not be distorted is the income for each year, viewed as separate units.

Our construction of Section 43 is supported not only by the words of the statute, but by its legis-

lative history and by the decisions of this Court. Moreover a contrary construction would upset long established principles of tax accounting and would raise problems which are hardly soluble within the framework of the statute.

Even if it be assumed that the "unless" clause of Section 43 introduces a transaction theory of taxation, it is nevertheless not applicable here. The payments which the taxpayer made in 1936, 1937 and 1938 were made only to regular customers and a large number of other customers were ignored. In no sense were these payments a cost of producing the 1935 income; they looked more to the future than to the past.

ARGUMENT

THE TAXPAYER IS NOT ENTITLED TO DEDUCT FROM ITS GROSS INCOME FOR 1935 THE PAYMENTS WHICH IT MADE TO ITS CUSTOMERS IN 1936, 1937, AND 1938

1. In the years 1936, 1937, and 1938 the taxpayer paid to some of its customers amounts totaling $45,865.90. It seeks to deduct this item from its gross income for the year 1935 under Section 23 (a) of the Revenue Act of 1934, *supra*, which allows the deduction from gross income of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Assuming that the item was a business expense within the meaning of

this provision[2] and thus was deductible at some time, it was plainly neither paid nor incurred during 1935. It is well settled that taxpayers on the accrual basis of accounting may not accrue a deduction until the fact of liability becomes fixed and certain. *Lucas* v. *American Code Co.*, 280 U. S. 445; *North American Oil* v. *Burnet*, 286 U. S. 417, 424; *Brown* v. *Helvering*, 291 U. S. 193; *Dixie Pine Products Co.* v. *Commissioner*, No. 84, this Term. Here the taxpayer not only successfully took the position that the Miller's Federation Contract imposed no obligation upon it to make refunds to its vendees,[3] but following the advice of counsel it carefully refrained from making any commitment to them throughout the year 1935.[4]

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[2] It is arguable that at least to the extent that the payments were made to keep the good will of the customers, they are not deductible at all under *Welch* v. *Helvering*, 290 U. S. 111. See the dissenting opinion of Judge Thomas in *Helvering* v. *Cannon Valley Milling Co.*, 129 F. 2d 642, 649 (C. C. A. 8th). We refrain from pressing the point, however, in view of the ruling of the Bureau of Internal Revenue in G. C. M. 20134, 1938-1 Cum. Bull. 122.

[3] The taxpayer was correct in its interpretation of the Miller's Federation Contract. See *Moundridge Milling Co.* v. *Cream of Wheat Corp.*, 105 F. 2d 366 (C. C. A. 10th); *Johnson* v. *Igleheart Bros.*, 95 F. 2d 4 (C. C. A. 7th), certiorari denied, 304 U. S. 585.

[4] The taxpayer urged before the Board of Tax Appeals that the promises which it had made to some of its vendees to treat them fairly had constituted an acknowledgment of liability on its part. But the Board found that this was not the fact. The Board said (R. 42):

"* * * We do not agree with this contention. The so-called 'treat fairly' agreements were no more than assurances

The requirement in Section 23 (a) that expenses be deducted in the year in which they are paid or incurred is, of course, but an expression of the fundamental principle upon which our system of income taxation is based, *viz*, that taxes are imposed "for annual periods, and the exaction for one year is distinct from that for any other". *Tait* v. *Western Md. Ry. Co.*, 289 U. S. 620, 624. Each year stands alone. The principle is fundamental and has been announced in numerous cases, e. g., *Lucas* v. *American Code Co.*, 280 U. S. 445; *Lucas* v. *Ox Fibre Brush Co.*, 281 U. S. 115; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 306; *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 326; *Brown* v. *Helvering*, 291 U. S. 193; *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493, 498; *Heiner* v. *Mellon*, 304 U. S. 271, 275, 276.

In *Lucas* v. *American Code Co., supra*, the taxpayer employed one Farquahar as sales manager for 18 years from January 3, 1919, the compensation to be a commission based on sales. In May 1919 it discharged him. Farquahar brought suit in July 1919 and the taxpayer defended, denying liability. The company, which was on the accrual

given by petitioner to its customers to retain their good will. The testimony of petitioner's officers indicates that they did not intend to bind petitioner to make any repayments to its vendees."

As the taxpayer has conceded, the Board's determination on this point is conclusive.

basis of accounting, set up a reserve on its books for the year 1919 equal to the commissions for that year and sought permission from the Commissioner to deduct the reserve in its return for 1919. The permission was refused. In 1922 judgment on Farquahar's suit was entered against the taxpayer and in 1923 the judgment was affirmed on appeal and paid. The taxpayer contended that it was entitled to deduct the amount of the judgment from its income for 1919, but the Court rejected the contention on the ground that it conflicted with the principle of separate annual periods.

In *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, the taxpayer was engaged from 1913 to 1915, inclusive, in carrying out a dredging contract with the United States. In its income tax returns for 1913 to 1916, the taxpayer added to gross income the payments made under the contract during each taxable year and deducted its expenses paid that year in performing the contract. The total expenses of the work far exceeded the total receipts, and the tax returns for 1913, 1915 and 1916 showed net losses, while that for 1914 showed net income. Work under the contract was abandoned in 1915, and in 1916 suit was brought against the United States to recover damages on the ground that the material to be dredged was not as represented in the contract. Final judgment was entered for the claim-

ant in 1920, under a holding that the recovery was upon the contract and was compensatory of the cost of the work. The sum received by the taxpayer in 1920 under the judgment equaled the amount by which the expenses under the contract had exceeded the receipts from it, plus accrued interest. In other words, the effect of the judgment was merely to make the taxpayer whole, and not to produce any profit to it on the dredging contract. The Circuit Court of Appeals had held that the amount of the judgment (exclusive of that part which represented interest) should be excluded from gross income for 1920 on condition that amended returns be filed for the years 1913 to 1916 from which were to be omitted the deductions of the related items of expense paid in those years. This Court reversed, stating the question to be (pp. 362–363):

> * * * whether the gain or profit which is the subject of the tax may be ascertained, as here, *on the basis of fixed accounting periods,* or whether, as is pressed upon us, *it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.* [Italics supplied.]

The Court stated (p. 363) that all of the Revenue Acts uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during the fixed accounting period of the calendar or fiscal year, either

upon a cash or an accrual basis, depending upon the method used. The amount of the judgment was held to be properly includible in the return for 1920 regardless of whether the particular transaction resulted in a net profit, because (pp. 364–365):

> Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. *The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.*
>
> * * * * *
>
> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely *whether the final outcome of the period, or of a given transaction,* will be a gain or a loss. [Italics supplied.]

The underlying reasons for the adoption by Congress of the annual system were stated as follows (p. 365):

> It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.

2. It is not denied by the taxpayer that its position collides directly with this basic principle of our system of income taxation. It is contended however that the departure is permissible in the instant case because (a) where the deductions of one year are closely related to the income of an earlier year, Section 43 allows the deductions to be referred back to the earlier year in order "to clearly reflect the income," and (b) there was here such a close relationship between the payments in 1936–1938 and the income for 1935 that there should be a relation back of the deductions. We submit that there is no merit in either of these points.[5]

(a) Section 43 of the Revenue Act of 1934 provides:

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[5] This is not a situation where the relation back may be justified for the purpose of correcting a mistake. In such cases other considerations may apply. See Brief for the Respondent in *Dixie Pine Products Co.* v. *Commissioner*, No. 84, this Term.

> The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

The taxpayer relies upon the "unless" clause of this section, contending that it is the purpose of this clause to countenance departures from the annual system. We agree that it is the purpose of the clause to allow deductions to be taken in a year other than that of payment or accrual, but we do not think that it goes so far as to countenance a departure from the annual system.

There are two possible constructions of the section: First, that it is to be read in harmony with the remainder of the statute; thus it permits the taking of a deduction in a year other than that in which the item is paid or incurred, *only when consistently with the annual nature of the tax* it is necessary to do so in order "to clearly reflect the income." Second, that the section is to be read as a denial of the annual system; thus it permits ignoring the fixed periods of return for the purpose of ascertaining the net result of particular transactions or the final outcome of a prior taxable period. We think that the first is the true meaning of the section. Not only must the section necessarily be read as part of the en-

tire statute, but its legislative history and the decisions of this Court support this view.

Section 43 with the "unless" clause first appeared in the revenue laws as Section 200 (d) of the Revenue Act of 1924, c. 234, 43 Stat. 253. The report of the House Ways and Means Committee [H. Rep. No. 179, 68th Cong., 1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) 241, 249)] stated:

> In subdivision (d) of this section authority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which "paid" or "accrued" when, in his opinion, it is necessary in order to clearly reflect the income. The Revenue Act of 1921 in sections 214 (a) 6 and 234 (a) 4 authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

The report of the Senate Finance Committee is to the same effect. See S. Rep. No. 398, 68th Cong.

1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) 266, 273). It will be observed that the committee reports specifically state that: "The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years."

It is apparent that there is a wide difference between the type of case referred to in the committee reports as the kind which Section 43 was designed to meet, and one in which, as here, the deduction is sought to be thrown into another year simply because an ancestor transaction took place then. To allow the proration of a prepayment of interest, or rental, or the like, over the period covered by the payment is not inconsistent with the annual nature of the tax. Such payments bear a great deal of similarity to capital expenditures, and a direction that in order to avoid distortion they be amortized over the period of years covered by the payment is not a denial but is, on the contrary, a recognition of the principle of separate fixed periods of return.

Section 43 must be read as part of an entire statute whose cornerstone is a system of separate fixed periods of return not only because it *is* a part of the statute, but, in fact, upon close analysis, any other construction seems to be impossible. The committee reports speak of the necessity of this provision in order to avoid "distortion" of income. In *Helvering* v. *Cannon Valley Milling Co.*, 129 F. 2d 642 (C. C. A. 8th), the court, and

in the instant case the taxpayer, lean heavily upon the proposition that it is necessary to relate the deduction back to the earlier year in order to prevent "distortion" of income. But distortion means departure from the norm, and it is impossible to tell whether there has been a deviation unless there is a standard by which to measure. The only criterion available is that afforded by the entire statute, namely, that each year is a separate period. And as was pointed out in the *Sanford & Brooks* case (p. 365) it is fundamental that under such a system there may be income subject to tax in one year, even though when the operations of that year are combined with those of other years the result is a loss. Viewed from the standpoint of the total operations over the period of years there may be a distortion in attributing income to one of those years; but viewed from the standpoint of each year there is no distortion. And so in the instant case it is *only by viewing all of the years as together constituting a single period* that it is possible to say that there is a "distortion" of income unless the payments made in 1936, 1937 and 1938 are related back to 1935.[6] But there is

[6] We think that even if Section 43 be construed to permit the fixed periods of return to be ignored for the purpose of determining the result of particular transactions, the deduction here may nevertheless not be referred to 1935, for there was no direct relationship between the income for that year and the payments in the later years. See page 33 *infra*.

no warrant in the statute for adopting such a standard. And if, as we submit, each year must be viewed separately, then as one of the dissenting opinions in the Board in the *Cannon Valley* case said (44 B. T. A. 763, 774): "Accounting for 1937 liabilities in 1935 will not clearly reflect 1935 income; it distorts the income of both years."

Indeed, even in the *Cannon Valley* case the majority opinion of the court was unwilling to construe the "unless" clause of Section 43 as introducing the principle that net income is to be computed on the basis of the ascertainment of the net result of particular transactions.

The court recognized the serious and undesirable results flowing from a construction of the clause as an exception to the annual principle; but it was of the view that where application of that principle resulted in "distortion," a departure was permissible. The court said (129 F. 2d 642, 645–646):

> To construe this clause broadly to cover all instances where there is merely some relation between a deductible item and a business transaction in some year other than the one in which it was paid or finally accrued would introduce an uncertainty seriously interfering with the practical administration of tax statutes. Clearly, no such general disturbance of the system was contemplated by section 43. There-

fore, such relationship alone is not enough. There must be, in addition to such relationship, a situation which clearly convinces that unless such deduction item is transferred there would be a *distortion* of the income of the taxpayer for one or both years, which would amount to an injustice either to the taxpayer or to the Government. We think the guide for construction of this "unless" clause is that it comprehends those exceptional situations where it is necessary to transfer a deduction item in order to avoid such a distortion of income as would produce an injustice. It is this guide we apply to the fact situation here.

However, as we have indicated, to speak of "distortion" as the test by which to measure the applicability of the "unless" clause is to beg the entire question. If the situation is eyed from the point of view of the results of a particular transaction, the effects of the transaction may be distorted by application of the annual principle. But the converse is also true; if the situation is eyed from the point of view of the annual system, the income of each year is distorted by application of the transaction theory. It therefore does not advance solution of the problem to speak of distortion; the question recurs: What is it which must not be distorted but must be clearly reflected? The answer suggests itself: The income of each year, viewed as separate units.

The decisions of this Court support the construction of Section 43 which we urge. In *Lucas v. Ox Fibre Brush Co.*, 281 U. S. 115, the taxpayer paid in 1920 additional compensation to certain of its officers for services rendered in prior years. Just as in the instant case the taxpayer was not bound by any prior agreement or legal obligation to make the payments to its vendees in 1936–1938, so in the *Ox Fibre* case (p. 119)—"there was no prior agreement or legal obligation to pay the additional compensation". The Commissioner there contended that he was entitled to allocate the deduction to the previous years in which the services were rendered, relying upon Section 212 (b)[7] of the Revenue Act of 1918, c. 18, 40 Stat. 1057, which contained a provision very similar to that of Section 43. Section 212 (b) of the 1918 Act provided that the net income should be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping his books, but it contained a proviso that "if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income." The Court rejected the Commissioner's contention, holding (p. 120) that "the expense could not be attributed to earlier years, for

[7] This section has been carried forward in all of the later acts. It is now Section 41.

it was neither paid nor incurred in those years." It is to be observed that the problem presented in the *Ox Fibre* case was essentially the same as that here involved: In which year should a deduction be taken in order clearly to reflect income? If the mandate that income must be "clearly reflected" meant that the principle of separate annual accounting periods should be disregarded, then the *Ox Fibre* case would necessarily have been differently decided. Indeed the instant case is *a fortiori*, for there was certainly a closer connection between the income of the earlier years and the payment in the later year in the *Ox Fibre* case than there is in the instant case between the income for 1935 and the payments made in 1936–1938.

In *Brown* v. *Helvering*, 291 U. S. 193, the taxpayer was a general agent for fire insurance companies. His income consisted, among other things, of "overriding commissions" on the business written by local agents in his territory. In the event of cancellation of a policy the taxpayer was required to return to the company a proportionate part of the commission. Thus the commissions received by the taxpayer in any one year were subject to reduction or diminution. Upon the basis of past experience the taxpayer, who was on the acrual basis of accounting, set up a reserve for each of the years from 1923–1926 for the portion of the commissions received in each year which would have to be returned to the companies,

and deducted that reserve from his gross income for each of those years. It is to be observed that the tax years involved in the case were 1923, 1925 and 1926, the latter two of which were years after the advent of Section 200 (d) of the 1924 Act. It was held that the deduction was not allowable. The Court, speaking through Mr. Justice Brandeis, pointed out that taxable income is computed for annual periods; the full amount of the overriding commissions was thus includible in gross income for the year in which they were receivable; however, since a liability cannot be accrued (p. 200) "as long as it remains contingent," but only when it becomes (p. 201) "fixed and absolute," there could be deducted in each year only that portion of the commissions which the taxpayer actually became liable to return in that year.

In *Guaranty Trust Co.* v. *Commissioner*, 303 U. S. 493, which involved the taxable year 1933, the Court said (p. 498):

> The items of gross income and of allowed deductions to be included in the income return, are those of the taxpayer for his taxable year, even though they may have resulted from or be affected by his business transactions of other years. *Burnet* v. *Sanford & Brooks Co.* * * *.

The foregoing are affirmative reasons for reading the "unless" clause of Section 43 harmoniously with the nature of the tax as one imposed

for annual periods. In addition there are weighty reasons against construing the clause as a denial of the annual system and thus permitting the ascertainment of the net result of particular transactions. To so construe Section 43 would mean that *Burnet* v. *Sanford & Brooks Co., supra*, has not been law since the enactment of the 1924 Act, and would cast doubt upon the validity of the regulations which for more than 25 years[8] have afforded to taxpayers optional methods of treating long-term contracts; they may report all the receipts and all the expenditures made on account of a particular contract in the year in which the work is completed, or they may report a part of the income each year upon the basis of percentage of completion. Indeed the effects of such a construction of Section 43 would be felt throughout the entire tax accounting structure.

In a case involving facts precisely like those in *Lucas* v. *Ox Fibre Brush Co., supra*, the deduction would have to be related back to the earlier years, for the compensation which was paid in 1920 was for services rendered in producing the income of the earlier years. Likewise in a situation similar to that involved in *Lucas* v. *American Code Co.*, 280 U. S. 445, the deduction for a judgment ren-

[8] Article 121 of Regulations 33 (1918 ed.); Article 36 of Regulations 45 (1920 ed.); Article 36 of Regulations 62, 65 and 69; Article 334 of Regulations 74 and 77; Article 42-4 of Regulations 86, 94 and 101; Section 19.42-4 of Regulations 103.

dered against the taxpayer would have to be related back to the year in which the cause of action arose. It might even be arguable under such a construction of Section 43 that where property is sold at a loss and the purchaser is to pay in installments, the loss should not be attributable to the year of sale, but should be spread over the period of the installment payments. See *Martin* v. *Commissioner,* 61 F. 2d 942 (C. C. A. 2d), certiorari denied, 289 U. S. 737; *Sacks* v. *Burnet,* 66 F. 2d 223 (App. D. C.).

Moreover, as was observed in the dissenting opinions in *E. B. Elliott Co.* v. *Commissioner,* 45 B. T. A. 82, departure from the principle of the annual system raises additional problems, problems which are hardly soluble within the framework of the statute. Suppose the years to which the deduction is sought to be related back are barred by the statute of limitations. By hypothesis the deduction is not properly to be taken in the later year, for that would result in "distortion." Is the deduction to be denied altogether? Suppose that some of the earlier years are barred by the statute of limitations and some are not. Should the entire amount of the deduction be allocated to those years which are still open, or, if only part of the deduction is to be related back, upon what basis should the allocation be made? The fact that Congress did not make correspondingly essential changes in the application of the statute of limitations strongly

supports the view that it was not intended by the "unless" clause of Section 43 to introduce a transaction theory of taxation.

(b) Assuming, *arguendo*, that the "unless" clause of Section 43 does allow the results of a transaction to be grouped into a single year notwithstanding that the transaction occurs over a period of years, we think that it is nevertheless not applicable here. The payments which the taxpayer made to its customers in 1936, 1937 and 1938 bore but a tenuous relationship to its income for 1935. To be sure, it is true that but for the fact that sales had been made in the earlier year, there would have been no occasion to make the payments in the later years, but this is hardly sufficient to tie them all together. In no sense were the payments an expense of producing the 1935 income. They were made only to the taxpayer's regular customers. A large number of casual customers, or customers toward whom the taxpayer felt no obligation, were ignored. Payments were not even made to all of those whom the taxpayer had promised to treat fairly. (R. 38.) The payments looked to the future, not to the past.

3. The taxpayer may renew here a contention which it made below, but which may be briefly dismissed. It was argued that $106,604.02 of the taxpayer's gross receipts in 1935 did not constitute income in that year. However, this amount was received as an inseparable part of

the price which was paid to the taxpayer for its goods, and the taxpayer was not under any restriction with respect to its use or disposition. And as both the Board of Tax Appeals and the Court below pointed out (R. 41–43, 63–64), it is well settled that amounts received under such circumstances constitute income in the year of receipt or accrual depending upon the system of accounting which is being used. *North American Oil* v. *Burnet*, 286 U. S. 417; *Brown* v. *Helvering*, 291 U. S. 193.

4. The court below did not err in reviewing the decision of the Board of Tax Appeals (now the Tax Court of the United States). Although *Dobson* v. *Commissioner*, Nos. 44–47, this Term, appears to lay down a salutary rule limiting judicial review of Board decisions in fact cases and thus to disapprove such decisions as *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, and *Bogardus* v. *Commissioner*, 302 U. S. 34, nevertheless such restrictions on review by the circuit courts of appeals can have no application where pure questions of law or statutory construction are involved. For the circuit courts of appeals have appellate jurisdiction in income, estate and gift tax cases from the federal district courts, as well as from the Tax Court. And it would indeed be strange if the content to be given to statutory language (here, Section 43) were to depend upon the fortuitous circumstance of

whether the first case to reach the circuit court of appeals on a particular issue originated in the Tax Court or in a federal district court. Certainly the present controversy could have begun as a suit for refund, if the taxpayer had decided to pay and then seek recovery. It should not be assumed, therefore, in the absence of a clear expression of legislative purpose, that Congress intended to make the meaning of any statutory provision in the tax laws depend upon whether the case that first reached the appellate courts came from the Tax Court or a district court.[9]

That the instant case raises a pure question of law is evident from the fact that the Tax Court rested its decision (R. 44) on this aspect of the case solely upon the authority of its prior decision in *Cannon Valley Milling Co.* v. *Commissioner*, 44 B. T. A. 763, which was affirmed by the Eighth Circuit in 129 F. 2d 642. Moreover, to the extent that a policy favoring administrative finality should control, it was the decision of the Tax Court that upset the determination of the Commissioner

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[9] The precise question in this case is one which Congress specifically intended the Circuit Courts of Appeals to review, since the House Report on the Revenue Bill of 1926 expressly states that Circuit Courts of Appeals "upon review may consider, for example, questions as to * * * the proper interpretation and application of the statute or any regulation having the force of law * * *." (Excerpt from H. Rep. No. 1, 69th Cong., 1st Sess., pp. 19–20.) Identical language is also to be found in the Senate Report (S. Rep. No. 52, 69th Cong., 1st Sess., p. 36).

of Internal Revenue which in turn was based upon Treasury Regulations long understood to support his action.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted,

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